

# Research & Development Credit:

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# Frequently Asked Questions

## What is the Research & Development Credit?

The Research and Development Credit, or R&D Credit, available to certain taxpayers, may reduce the taxpayer's income or franchise tax. To qualify for the R&D Credit, the taxpayer must have paid or incurred qualified research expenses while conducting research in California for a qualified activity. The credit is 15 percent of the excess of current year research expenditures over a computed base amount (minimum of 50 percent of current year research expenses). The credit is claimed on the return for the taxable year in which the qualified expenses are incurred.

## How is the R&D Credit claimed?

The R&D Credit is claimed on the California Research Credit (form FTB 3523), for the year in which the qualified research and development expenses were paid or incurred in California.

## Does California conform to federal R&D Credit provisions?

California law generally conforms to the federal research credit as enacted under the Small Business Job Protection Act of 1996. However, California does make some modifications. The more common modifications are:

1. The definition of "qualified organization" includes hospitals run by public universities and certain cancer centers.
2. "Basic research" and "qualified research" must be conducted in California to qualify for the California credit.
3. For taxable years beginning on or after 1/1/2000, the credit is 15 percent of qualified research expenses for all taxpayers. In addition, corporations (other than S Corporations, personal holding companies, and service organizations) may be eligible for the "basic research" credit, which is equal to 24 percent of the excess of basic research payments paid or incurred during the year over the base period amount. The qualified research rate was 11 percent for taxable years beginning in 1997 and 1998, and 12 percent for taxable years beginning in 1999. The basic research rate has been 24 percent since 1997.
4. California conformed to the Alternative Incremental Credit, except for some differences in the rates and the fact that California requires a separate election (from that of federal). For taxable years beginning on or after 1/1/2000, the percentages for the Alternative Incremental Credit are 1.49 percent, 1.98 percent, and 2.48 percent. For taxable years beginning on or after 1/1/1998, and before 1/1/2000, the percentages were 1.32 percent, 1.76 percent, and 2.20 percent. For taxable year 1997 the percentages were 1.65 percent, 2.20 percent, and 2.75 percent.

5. The credit cannot be carried back.
6. The definition of "gross receipts" differs.
7. The termination dates provided under federal law do not apply. Currently, there is no California termination date for this credit.

## What are basic research payments?

The term "basic research payment" means any amount paid in cash during the taxable year by a corporation (other than S corporations, personal holding companies, and service organizations) to a qualified organization for basic research, but only if such payment is made pursuant to a written agreement and the basic research is to be performed by the qualified organization in California. Qualified organizations include educational institutions, certain scientific research organizations, and certain grant organizations. For California, "basic research" includes any basic or applied research including scientific inquiry or original investigation for the advancement of scientific or engineering knowledge or the improved effectiveness of commercial products, but not if the improvements relate to style, taste, cosmetic, or seasonal design factors. For additional information, see the instructions for California form FTB 3523 regarding the taxable year the basic research payments may be claimed.

## What research activities qualify for the R&D Credit?

Research must meet four tests to be eligible for the R&D Credit. Internal Revenue Code (IRC) §41 states that the research activity must:

1. Qualify as a business deduction under IRC §174.
2. Be undertaken to discover information that is technological in nature.
3. Be undertaken to discover information intended to be useful to develop a new or improved business component.
4. Substantially involve a process of experimentation. Federal courts have interpreted this to mean 80 percent or more of the research activity.

If the research activity does not meet any one of these requirements, it is not considered a qualified research activity for purposes of the R&D credit.



## What research activities are excluded from the R&D Credit?

IRC §41 also specifically excludes research activities relating to the following:

1. Research undertaken outside of the United States. (For California purposes, its credit excludes research conducted outside of California.)
2. Research conducted in the social sciences or humanities.
3. Ordinary testing or inspection of materials or products for quality control.
4. Market and consumer research.
5. Research relating to style, taste, cosmetic, or seasonal design.
6. Advertising and promotional expenses.
7. Management studies and efficiency surveys.
8. Computer software for internal use of the taxpayer, unless it meets additional tests.
9. Research to locate and evaluate mineral deposits, including oil and gas.
10. Acquisition and improvement of land and of certain depreciable or depletable property used in research (including the annual depreciation deduction).
11. Research after commercial production.
12. Funded research - Any research funded by any grant, contract, or otherwise by another person (or governmental entity).

## What are qualified research expenses?

Qualified research expenses generally include wages, supplies, and contract research costs.

*Wages* – Qualifying wages are for qualified services that directly relate to the research activities and are paid or incurred by the taxpayer. Qualified services include direct supervision, direct support, or direct performance of qualified research. General or administrative wages generally do not qualify. For example, an allocated portion of the purchasing or receiving department's wages would not qualify because these are indirect costs and are incidental to research activity.

Compensation considered for purposes of determining the credit includes, but is not limited to, salaries, wages, and taxable income from non-qualifying stock plans or disqualifying dispositions of incentive stock options.

*Supplies* – Supplies include tangible property that is consumed directly by the research activity or that is utilized in the development of a prototype. The supplies must be used in the conduct of qualified research. Supplies do not include land, improvements to land, or property subject to the allowance for depreciation. Utilities (phone and electricity), small tools, and allocations of total shipping cost do not qualify as supply expenses.

*Contract* – Contract research expenses are amounts paid to non-employees (outside consultants) to perform qualified research. The taxpayer must enter into written agreement prior to performance and bear the costs even if the research is unsuccessful. The consultant must perform the research within California. If the research is conducted within and without California, then the expense should be prorated between those in state and those out of state. Only 65 percent of the California expense qualifies for the credit.

## Are payments for fringe benefits or profit sharing plans qualified research credit expenses?

No. IRC §41 grants a tax credit for increasing research activities, which is calculated using the amount constituting a taxpayer's qualified research expenses. In defining qualified research expenses to include wages for qualified services, the code provides that wages will have the same meaning given under IRC §3401(a), which defines wages for collection of income tax at source. Under IRC §3401(a), the term "wages" specifically excludes certain remuneration for employment, including employer contributions to tax-qualified trusts (payments to a qualified profit-sharing plan under Section 401 would not qualify as qualified wages under IRC §41(b)(2)(D)).

If certain remuneration is excluded from the meaning of wages under IRC §3401(a), it cannot constitute wages or qualified research expenses under IRC §41 for purposes of calculating a tax credit for increasing research activities.

## What is the definition of "gross receipts" for California purposes?

California gross receipts include receipts minus returns and allowances from the sale of real, tangible, or intangible property held for sale to customers in the ordinary course of the taxpayer's trade or business that is delivered or shipped to a purchaser within California, regardless of free on board point or other condition of sale. This would include sales to the U.S. government, which could be identified as delivered in California. Excluded receipts would be items such as "throwback" sales, as well as, receipts from services, rents, operating leases and interest. In addition, royalties and license payments would generally be excluded from the definition of gross receipts for research credit purposes. This California definition of gross receipts applies to both the average annual gross receipts for the prior four years and the base years (1984-1988). For aggregation purposes, the "gross receipts" figures used in the base amount calculations (the "average annual gross receipts" and the "aggregate gross receipts" of the fixed-base percentage) should reflect those from the entire "controlled group" (even when only one corporation has research expenses). Using the "gross receipts" of the entire controlled group reflects an accurate comparison of the research expenditures to the business as a whole.

## Does the R&D Credit have to be added back into income as a California state adjustment?

For taxable years after December 31, 1989, IRC §280C(c) [Bank and Corporation Tax Law §24440] disallows a deduction under IRC §174 for the taxable year equal to the amount of the R&D Credit determined for the year, so the taxpayer will not receive a tax benefit for the expenses twice. This creates an addition to income in the amount of the credit (in order to decrease the IRC §174 research and development expense deduction). Note that due to differences in the federal and California credit amounts, the California return may require state adjustments, especially if the California return begins with the federal taxable income.

Taxpayers may avoid the reduction of their research and development expenses by electing to take a reduced credit in accordance with IRC §280C(c)(3). This election provides that the research credit will be reduced by the amount of tax savings created by the double tax benefit. The maximum tax rates are used for this computation. On California form FTB 3523 (Research Credit), corporations multiply their research credit by 91.16 percent (.9116), individuals and estates or trusts multiply their research credit by 90.7 percent (.907), and S corporations multiply their research credit by 98.5 percent (.985) to arrive at the reduced credit amount. This irrevocable election must be made on the original California return filed on or before the due date for filing the return, including extensions. The election cannot be made on an amended return.

### *Example:*

Corp A generates an R&D credit of \$100,000 for the taxable year ending 12/01.

Corp A can elect on a timely filed original return to reduce the credit to \$91,160 by applying the applicable credit reduction percentage:

$$\{(100,000 \times .9116) = \$91,160\}.$$

If Corp A uses \$50,000 in 12/01, it can use the remaining \$41,160 in 12/02 with no further reduction. (Please check California form FTB 3523 for the applicable credit reduction percentage for years other than 2001.)

If Corp A does not elect to reduce the R&D credit, it will have to reduce its R&D expenses in 12/01 by the entire \$100,000 amount of credit generated even though it can only use \$50,000 of the credit in 12/01.

In 12/02, Corp A generates an additional R & D credit of \$30,000. Corp A has a choice to either reduce the credit by the applicable credit reduction percentage (this is an annual election) or reduce the R&D expenses by the amount of the credit generated. If Corp A elects to reduce the credit,  $\{(30,000 \times .9116) = \$27,348\}$ , it will have \$68,508 in R & D credit to use in 12/02 (\$27,348 current year credit + \$41,160 carryover credit from 12/01).

Note: Amounts received from S corporations, estates or trusts, partnerships and LLCs taxed as partnerships may be limited due to IRC Section 41(g) and the related regulations.

## If taxpayers want to reduce their research and development expenses by the amount of the credit rather than applying the applicable credit reduction percentage to the credit, how do they get FTB permission?

The addback is required any time the annual IRC §280C(c) reduced credit option election is not made, so no permission is needed. The IRC §280C(c) election to reduce the credit can be made simply by completing the reduced credit line on California form FTB 3523. Taxpayers can make different elections for federal and state purposes.

## Can the credit reduce the alternative minimum tax?

No. The credit cannot reduce the alternative minimum tax; however, the credit may reduce the regular tax below the tentative minimum tax. See Schedule P (Forms 100, 100W, 540, 540NR, or 541) for more information. Any research and development credit that is not used to offset the qualified taxpayer's income or franchise tax must be carried over to future years.

## Can the same expenses be used for the Research & Development and Manufacturers' Investment Credits?

In general, the expenses that would qualify for the Manufacturers' Investment Credit would not qualify for the R&D Credit. Expenses qualifying for the Manufacturers' Investment Credit are capital in nature and subject to depreciation or depletion. IRC §41(b) specifically prohibits the inclusion of these types of expenses for the R&D Credit. This is true whether the taxpayer has or has not claimed depreciation.



For example, a taxpayer purchased 50 computers at a cost of \$200,000 (50 computers x \$4,000 each) and depreciated these over a 5 year period for a resulting depreciation expense of \$40,000 a year (straight-line method). Neither the depreciation expense nor the original cost of the computers would qualify for R&D Credit treatment.

### **Can a taxpayer amend a prior year return to claim a qualified R&D tax credit?**

Yes, as long as the applicable statute of limitations is open (generally four years from the original due date of the return, or one year from the date of the overpayment, whichever period expires later).

### **Is the R&D Credit a refundable credit?**

No. Any research and development credit that is not used to offset the qualified taxpayer's income or franchise tax must be carried over to future years.

### **What is a start-up company?**

A start-up company is one that had both gross receipts and qualified research expenses either:

- For the first time in a taxable year beginning after December 31, 1983; or
- For fewer than three taxable years beginning after December 31, 1983, and before January 1, 1989.

The fixed-base percentage for a start-up company is 3 percent for each of the company's first five taxable years beginning on or after January 1, 1994, that the company has a qualified research expense. There is a ten-year phase-in period leading up to a credit based on five years of experience. During the phase-in period, 3 percent continues to be used as the fixed-base percentage for a start-up company, but only during each of the company's first five taxable years beginning after 1993 for which it has a qualified research expense. For a start-up company's fixed-base percentage for its sixth through tenth years beginning after 1993, see IRC Section 41(c)(3)(B)(ii).

### **What are the aggregation rules?**

For purposes of the research credit, all members of a "controlled group" are to be treated as a single taxpayer. All of the components that comprise the R&D Credit calculation are aggregated and the total R&D Credit generated is computed as if the controlled group is a single taxpayer. The total R&D Credit amount is then assigned to the members of the controlled group based upon their proportionate share of the qualified research expenses and basic research payments. It should be noted the aggregation rules apply to controlled trades and businesses as well as controlled corporations. Controlled trades and businesses include sole proprietorships, partnerships, and estates and trusts.

### **What is the definition of a "controlled group" for R&D Credit purposes?**

Treasury Regulation §1.41-8(a) provides a bright line ownership test for inclusion in a controlled group. In general, parent/subsidiary groups and brother/sister groups, as defined under Treasury Regulation §1.52-1(b)-(g), in which the taxpayer either holds a "controlling interest" of entities, or is part of a group owned by another entity that holds a "controlling interest" in the taxpayer and other entities, will be considered members of the same controlled group for R&D Credit purposes.

In the case of corporations, a controlling interest is defined as more than 50 percent of the combined voting power of all classes of stock or more than 50 percent of the total value of shares of all classes of stock. The terms "interest" and "stock" do not include treasury stock or nonvoting stock that is limited and preferred regarding dividends. In the case of partnerships, a controlling interest is defined as more than 50 percent of a profit or capital interest, and in the case of an estate or trust, a controlling interest is defined as more than 50 percent of an actuarial interest.

### **Is the "controlled group" of corporations for R&D Credit aggregation purposes the same as the "unitary group" for combined reporting purposes?**

No. The "controlled group" is not necessarily restricted to the entities included in the combined report and may include non-unitary affiliates.

### **Is the "controlled group" restricted to entities either currently or historically conducting research?**

No. The "controlled group" is generally comprised of all entities commonly owned more than 50 percent. However, the controlled group can be considered restricted to entities with California research or gross receipts for California purposes.

Current or historical research entities will include both California qualified research expenses and California gross receipts in the "base amount" or current qualified expense components. Non-research entities impact the "base amount" component only. In other words, the California gross receipts of the non-research entities are included in the computations of the fixed-base percentage and annual average gross receipts.

## Related Forms and Publications

**Credit for Increasing Research Activities (IRS Form 6765):** This is the form and instructions for claiming the tax credit on your federal income tax return.

You can get this federal document from the Internal Revenue Service at [[www.irs.ustreas.gov/prod/forms\\_pubs/index.html](http://www.irs.ustreas.gov/prod/forms_pubs/index.html)], or from your local IRS office.

**Research Credit (form FTB 3523):** This is the form and instructions for claiming the tax credit on your state income tax return.

## Where Do I Get More Information?

### *Internet*

You can get Franchise Tax Board Research and Development Credit forms and other information about your state income tax from our Website:

[www.ftb.ca.gov](http://www.ftb.ca.gov)

### *Telephone*

Telephone assistance is available year-round from 7 a.m. until 8 p.m. Monday through Friday. From January through June, assistance is also available from 8 a.m. until 5 p.m. on Saturdays. We may modify these hours without notice to meet operational needs.

From within the U.S.	(800) 852-5711
From outside the U.S.	(916) 845-6500 (not toll-free)

**Assistance for persons with disabilities:** We comply with the Americans with Disabilities Act. Persons with hearing or speech impairments please call TTY/TDD (800) 822-6268.

### *Mail*

You can also order these forms by writing to:

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FRANCHISE TAX BOARD  
PO BOX 307  
RANCHO CORDOVA CA 95741-0307